

1 **BEFORE THE ARIZONA CORPORATION COMMISSION**

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CHAIRMAN
3 GARY PIERCE
COMMISSIONER
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COMMISSIONER

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8 IN THE MATTER OF THE APPLICATION OF
9 PIMA UTILITY COMPANY, AN ARIZONA
10 CORPORATION, FOR A DETERMINATION OF
11 THE FAIR VALUE OF ITS UTILITY PLANT AND
12 PROPERTY AND FOR INCREASES IN ITS
13 WATER RATES AND CHARGES FOR UTILITY
14 SERVICE BASED THEREON.

Docket No. W-02199A-11-0329

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22 UTILITY SERVICE BASED THEREON.

Docket No. SW-02199A-11-0330

**RUCO'S MOTION TO REHEAR
DECISION NO. 73993**

23
24 Pursuant to A.R.S. § 40-253, the Residential Utility Consumer Office ("RUCO")
requests that the Arizona Corporation Commission ("Commission") rehear Decision No.
73993 docketed July 16, 2013. Decision No. 73993 approved Pima Utilities ("Pima" or
"Company") Petition to Amend Decision No. 73993 to impute income tax expense.

1 **BACKGROUND**

2 On July 16, 2013, the Commission issued Decision No. 73993, which established
3 the current rates for Pima¹ This Decision amended the rates that had been set for Pima in
4 Decision No. 73573, issued November 21, 2012. Decision No. 73573 also provided that
5 Pima could seek an allowance for income taxes generated as a result of its operations if the
6 Commission changed its policy regarding the treatment of income taxes for subchapter S
7 corporations².

8 On February 21, 2013, in Decision No. 73739, the Commission adopted a policy
9 allowing every utility entity, other than subchapter C corporations and tax-exempt entities, to
10 seek to include in its cost of service an income tax allowance based on the lower of
11 comparable subchapter C corporate income tax expense, or the combined personal income
12 tax obligation created by the distribution of the utility's profits.

13 On March 29, 2013, the Company filed a petition to amend Decision No. 71854
14 pursuant to Arizona Revised Statutes ("A.R.S.") § 40-252. The increase to the revenue
15 requirement for water customers is \$152,666, or an increase of 7.75 percent, and the
16 increase to the revenue requirement for wastewater customers is \$168,722, or an increase
17 of 5.45 percent.

18 In its filing, the Company is not proposing any changes to its fair value rate base,
19 which is \$9,122,677 for its water division and \$9,895,103 for its wastewater division.
20 Adopting the increases proposed by the Company would increase the Company's revenue
21 requirements to \$2,550,282 and \$3,400,935 for its water and wastewater divisions,
22

23 ¹ For the most part RUCO agrees with the background set forth in Decision No. 73573 which is followed here.

24 ² See Decision No. 73573 at 29.

1 respectively. For the water division, the FVROR remains at 7.63 percent, or may become
2 9.30 percent, depending on the ratemaking classification for the income tax issue. For the
3 wastewater division, the FVROR remains at 7.63 percent, or may become 9.30 percent,
4 depending on the ratemaking classification for the income tax issue, The Company's
5 current rates, based on a 2010 test year, were approved in Decision No. 73573. In that
6 case, the Company requested recognition of income tax expense in its application, but it
7 was held open as the Commission's policy at that time did not recognize income tax for
8 pass-through entities that had no income tax liability. However, also at that time, the
9 Commission was in the process of evaluating changes to this policy, which ultimately
10 resulted in Decision No. 73739. The matter was heard at the Open Meeting held on June
11 27, 2013 and on July 16, 2013; the Commission docketed Decision No. 73992. Decision
12 No. 73992 approved Pima Utilities ("Pima" or "Company") Petition to Amend Decision No.
13 73573 to impute income tax expense.

14 **1) ALLOWING A SUBCHAPTER S CORPORATION OR LLC TO RECOVER**
15 **INCOME TAX FROM RATEPAYERS WOULD VIOLATE THE**
16 **COMMISSION'S CONSTITUTIONAL OBLIGATION TO PRESCRIBE JUST**
AND REASONABLE RATES.

17 **a. The Company's proposal violates Arizona's Constitution because**
18 **the Commission's process does not properly consider fair value.**

19 The Commission is prohibited from opening up a rate case with a test year that is
20 over two years old for the purpose of increasing rates based on a new single expense
21 without a meaningful fair value analysis. The Arizona Corporation Commission is
22 established by Article 15, Section 1 of the Arizona Constitution. The Commission's authority
23 is derived from Article 15, Section 3, which provides, in relevant part, that the Commission
24 "shall have full power to, and shall, prescribe just and reasonable classifications to be used

1 and just and reasonable rates and charges to be made and collected, by public service
2 corporations within the State for service rendered therein.” Ariz. Const. Art. 15, § 3.

3 Although the Commission's authority to prescribe rates is plenary, Tucson Elec.
4 Power v. ACC, 132 Ariz. 240, 242, the Commission's rate-making authority is not unlimited
5 and is subject to the “just and reasonable” clauses of Article 15, Section 3 of the Arizona
6 Constitution. The Constitution obligates the Commission to consider and protect the
7 ratepayers’ interests when determining “just and reasonable rates.”

8 The Commission was created by the states Founding Fathers to shield the
9 ratepayers against overreaching by public service corporations. Deborah Scott Engleby,
10 “The Corporation Commission: Preserving its Independence,” (20 Ariz. St. L.J. 241, 242
11 (1988)) At the time of Arizona’s Constitutional Convention, there was such a feeling of
12 mistrust of government, including future legislatures, that the delegates, in order to
13 guarantee “the people security against the dominance of corporate and corrupt control of
14 public affairs...” safeguarded against any legislative encroachment by giving the Legislature
15 authority to enlarge the Commission’s powers, but no authority to diminish them. Id. at 244.
16 The result was a public service commission with more power than any other state at the
17 time. State v. Tucson Gas, 15 Ariz. 294, 300, 138 P. 781, 783 (1914).

18 The Arizona courts have long since recognized the Commission’s constitutional
19 obligation to protect the financial interest of the consumer. See for example Southern Pac.
20 Co. v. Arizona Corp. Comm’n, 98 Ariz. 339, 342, 404 P.2d 692, 694 (1965), and also
21 Cogent Public Service v. Ariz. Corp. Comm’n., 142 Ariz. 52, 56, 699 P.2d 698, 02 (App.
22 1984) (“It has long been the policy of our courts to recognize that the setting of utility rates
23 must take into account the interests of utility customers as well as utility shareholders.”).
24

1 The Arizona Supreme Court has even said that the people of Arizona created the
2 Commission primarily for the interests of the consumer.

3 “All persons agree that the capital invested in public service
4 should receive reasonable remuneration, and that the services
5 rendered should be efficient and practicable and to all patrons
6 upon equal terms and conditions. With a full knowledge that these
7 things had not been accomplished under the laws heretofore
8 existing in this and other jurisdictions, the people in their
9 fundamental law created the Corporation Commission, and
10 clothed it with full power to investigate, hear, and determine
11 disputes and controversies between public utility companies and
12 the general public. This was done primarily for the interest of the
13 consumer.” (Tucson Gas, supra at 307-308, 138 P. 781-786)

14 Clearly and without question the Commission was given unique and extensive powers
15 primarily to protect the consumers’ financial interests.

16 In order to prescribe rates that are just and reasonable and protect the consumer’s
17 financial interests, Arizona’s Supreme Court has held that when setting rates for public
18 utilities, the Commission must find the fair value of the property.

19 The “fair value of the property” of public service
20 corporations is the recognized levels upon which rates and
21 charges for services rendered should be made, and it is made the
22 duty of the Commission to ascertain such value ...for its own use,
23 in arriving at just and reasonable rates... 80 Ariz. At 151 (citation
24 omitted)

...the Commission is required to find the fair value of the
company’s property and use such finding as a rate base for the
purpose of calculating what are just and reasonable rates. 80 Ariz.
at 151.

The reasonableness and justness of the rates must be
related to this finding of fair value. 80 Ariz. At 151 (emphasis
added)

1 The Company petitioned under A.R.S. Section 40-252 to amend Decision No. 73573
2 which was docketed on December 21, 2012. Decision No. 73573 decided the Company's
3 rate case which was filed on August 29, 2011. The test year in the rate case ended
4 December 31, 2010. Now, more than two years from the end of the test year, the
5 Commission seeks to open the rate case to for the purpose of raising the ratepayer's rates to
6 include an imputed income tax expense. There is no question of an adjustor nor is there a
7 question of emergency rates. This is simply an extraordinary ratemaking measure
8 implemented in a manner to side-step Arizona's fair value requirement.

9 There is nothing exceptional about this case that warrants extraordinary ratemaking.
10 The Commission has recently changed its policy to allow for the recovery of income tax
11 expense for pass-through entities. The previous policy was in place since the mid-1980s.
12 While the shareholders of the utility would like to recover their personal income taxes paid as
13 soon as possible, this is hardly a pressing matter that cannot wait until the Company files its
14 next rate case. In a rate case all of the Company's expenses and other rate case elements
15 would be considered and there would be a meaningful fair value determination.

16 Instead, the only expense being considered in the current process is the imputed
17 income tax. In *Scates v. Ariz. Corp. Comm'n*, 118 Ariz. 531, 535, 578 P.2d 612, 616 (App.
18 1978), Mountain States Telephone and Telegraph Company applied for an increase in rates.
19 The Commission approved the increase without any examination of the costs of the utility
20 apart from the affected services, without any determination of the utility's investment, and
21 without any inquiry into the effect of this substantial increase upon Mountain States' rate of
22 return on that investment. The Court held that the Commission's action was in violation of
23 Arizona's constitutional provisions regarding rate making. *Scates v. Ariz. Corp. Comm'n*, 118
24

1 Ariz. 531, 533, 578 P.2d 612, 614 (App. 1978). The *Scates* court further went on to note that
2 such a piecemeal approach to ratemaking is fraught with potential abuse. *Scates*, 118 Ariz.
3 At 534, 578 P.2d 612, 615. The Court's reasoning is applicable here. The current process
4 for the most part guarantees that no relationship exists between the variables used to
5 consider the Company's rate base in the rate case and the tax calculation in this case.
6 There is no meaningful fair value determination associated with the Company's petition nor
7 is there an exceptional circumstance and the Commission should rehear the matter.

8
9 **b. ALLOWANCE OF AN INPUTED INCOME IMPACTS THE**
10 **COMPANY'S RATE OF RETURN**

11 The allowance of pass-through income tax simply permits the Company to gain an
12 additional profit from its customers under the guise of recovering operating expenses. The
13 impact is that the Company is allowed a higher return than what the Commission approved
14 in the underlying rate case. Staff alluded to it in its report and Decision 73993 even
15 acknowledges it to some extent in paragraphs 12 – 14. According to Staff (and the
16 Decision), a change in the regulatory classification of the expense could result in a FVROR
17 of 9.30 and 9.34 percent. The Decision classifies the expense differently than what is
18 stated in the Commission's policy in order to avoid impacting the FVROR which is the
19 "intent of the Commission's policy." In other words, the intent of the Commission's policy is
20 different than what the policy states.

21 While Staff believes the classification of the expense determines the impact on the
22 FVROR, it is elementary that increasing the Company's revenues to make up for an
23 expense that does not exist, will result in an increase to the Company's net income, which
24 in turn will in turn will increase the Company's ROR.

1 **2) BECAUSE SHAREHOLDERS MAY HAVE DIFFERENT INDIVIDUAL TAX**
2 **RATES AND DIFFERENT OFFSETS, ANY RATE THE COMMISSION SETS**
3 **WOULD BE ARBITRARY, CAPRICIOUS AND AN ABUSE OF**
4 **DISCRETION.**

5 The imputation of non-existent income tax expense in the manner that the
6 Commission has proposed in this case is arbitrary, capricious and an abuse of discretion.
7 The Commission imputed an amount of income tax expense that is not based on the
8 shareholder's actual income tax, therefore, guaranteeing that the shareholders will recover
9 an amount that is not based on their actual income taxes. The Commission could have
10 easily required the shareholders to produce their actual income tax records in order to
11 recover the expense. The Commission's imputation methodology in this case is arbitrary,
12 capricious and, therefore, an abuse of discretion.

13 The calculation of corporate income tax and personal income tax are completely
14 different. Taxable income for a C corporation for example is based on the net income from
15 the business. Taxable income for the individual is based on the transfer of income in any
16 number of ways including salaries, interest, dividends, supplemental income, etc. The
17 individual income tax rate will be the same for all of those income sources with no
18 preferential tax treatment for any source in particular. There is no fair way to reconcile the
19 shareholder's personal income tax with a corporate income tax rate that will guarantee that
20 ratepayers will pay an appropriate and fair amount of income tax. About the best that can
21 be done is to "damage" the ratepayer as little as possible.

22 The Commission is obligated to set rates that are just and reasonable. The
23 Commission must base those rates on the Company's operating costs. The Commission
24 cannot legally base rates on operating costs that do not exist. The Company's proposal
 violates Arizona's law.

1 **3) THE COMMISSION’S METHODOLOGY FOR IMPUTING TAXES IS**
2 **CONTRARY TO THE WEIGHT OF AUTHORITY IN OTHER STATES.**

3 The issue of whether the Commission can allow or disallow income tax expense is
4 not a case of first impression in Arizona. The Court of Appeals, in *Consolidated Water*
5 *Utilities, Ltd. v. Arizona Corp. Com’n*, 178 Ariz. 478, 484, 875 P.2d 137, 143, Ariz.App. Div.
6 1, 1993 (September 07, 1993) determined that the decision to allow or disallow tax expense
7 for pass-through entities “... is to be made by the Commission, not the courts.” Because
8 the Court upheld the Commission’s decision to disallow the expense, the Court did not
9 decide and did not rule on the method of imputation proposed in that case. The
10 Commission’s methodology for calculating the tax allowance in this case is not only
11 inconsistent with FERC it is contrary to the weight of authority in the few states that have
12 authorized an income tax allowance for pass through entities. Ironically, it was the
13 Commission who argued before the Arizona Court of Appeals in the *Consolidated* case that
14 “The issue of taxes that are actually paid dominates in states which have authorized
15 inclusion of income taxes even for entities that do not directly incur income taxes.”³ The
16 Commission made this argument to show that a theoretical tax allowance, such as what the
17 Commission has approved in the current case, would be arbitrary and inappropriate.

18 In its Answering Brief in *Consolidated*, the Commission distinguished other states (in
19 particular New Mexico and Texas) that have approved a tax allowance:

20 The Moyston court recognized that it was deciding a case
21 of first impression and imposed what it recognized to be a
22 hypothetical tax based on its understanding that an actual tax was
23 paid, 412 P.2d at 850. The Suburban Court notes that Moyston is
24 the only decision of a court of last resort on the issue. After noting

23 ³ See Appellee Arizona Corporation Commission’s Answering Brief at 29-33, *Consolidated Water Utilities,*
24 *Ltd. v. Arizona Corp. Com’n*, 178 Ariz. 478, 875 P.2d 137 Ariz.App. Div. 1, 1993, (September 07, 1993), 1
CA-CC 92-0002. The relevant excerpt of the Answering Brief is attached hereto as Attachment 1.

1 that the Public Utility Commission had recently approved the
2 imputation of federal income tax liability for a Subchapter S utility,
3 the Suburban court held "...that Suburban is entitled to a
4 reasonable cost of service allowance for federal income taxes
5 actually paid by its shareholders on Suburban's taxable income or
6 for taxes it would be required to pay as a conventional
7 corporation, whichever is less. " 652 S.W.2d at 363, 364
8 (emphasis added).

6 While the Suburban case remains valid law in Texas, its
7 effects have been somewhat mitigated. In Southern Union Gas
8 Company v. Railroad Commission of Texas, 701 S.W.2d 277
9 (Tex.App. 3 Dist. 1985), the Texas Court of Appeals refined the
10 Suburban doctrine somewhat, noting "... the Commission did not
11 abuse its discretion in disallowing "theoretical" income tax liability
12 for rate making purposes." 701 S.W.2d at 279. The Southern
13 Union decision is cited approvingly by the Texas Supreme Court
14 in Public Utility Commission of Texas v. Houston Lighting & Power
15 Company, 748 S.W.2d 439 (Tex. 1987), in which theoretical
16 income tax liability is also disapproved.

12 The most recent word on the topic of taxes actually paid is
13 found in Kansas and it is particularly apposite in the current
14 situation. In Greeley Gas Co. v. State Corporation Commission,
15 807 P. 2d 167 (Kan.App. 1991), the Kansas Court of Appeals,
16 while noting that Suburban appeared to still be good law in Texas,
17 affirmed the Kansas Corporation Commission's disallowance of
18 income taxes based on the utility's failure to produce the
19 taxpayer's income tax returns to demonstrate what income taxes
20 were actually paid, if any, noting that the individual shareholders
21 particular situation could cause the tax rate to vary across the
22 various tax brackets that exist, 807 P.2d at 169, 170. ...
23 (Emphasis added in the original)

18 As the Commission argued in the *Consolidated* appeal, the issue of theoretical
19 income taxes in the current case is "squarely joined." The Commission, at least in the past,
20 has clearly recognized that a theoretical tax allowance such as that which the Commission
21 has approved here is arbitrary in the case of pass through entities and has taken a position
22 at the Court of Appeals against such a methodology as well as the tax allowance.

4) AS A MATTER OF PUBLIC POLICY, ALLOWING A LIMITED LIABILITY COMPANY OR A SUBCHAPTER S CORPORATION TO RECOVER INCOME TAX FROM RATEPAYERS IS POOR PUBLIC POLICY.

RUCO objects to Pima's request to impute income tax expense for all of the reasons cited in the underlying case as well as Commissioner Brenda Burn's Dissenting Opinion to the Commission's Policy Statement dated February 21, 2013. To the extent applicable, RUCO incorporates all of the arguments it made in the underlying docket. Requiring Pima's ratepayers to pay for a "phantom tax" which Pima as a corporate entity itself does not pay is not only unfair, it is wrong and will result in unfair and unreasonable rates based on poor public policy.

5) CONCLUSION

For the above reasons, RUCO respectfully requests that the Commission rehear Decision No.73993.

RESPECTFULLY SUBMITTED this 31st day of July, 2013.

/s/

Daniel W. Pozefsky
Chief Counsel

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